Message from State Auditor Troy Kelley

As I begin my third year as Washington State Auditor, I look back on two years of change and accomplishment. I look forward to an even more productive and instructive year as we fulfill our mission of holding state and local government accountable for the use of public resources. We will continue to pursue our vision of government that works for citizens, by helping governments work better, cost less, deliver higher value, and earn greater public trust.

Guiding us toward this vision are our organizational values of independence, respect, and integrity.

We also hold ourselves accountable for our use of public resources. We continue to use Lean principles to streamline our administrative and audit processes and to efficiently manage data, using it to measure and improve our performance.

State and local governments provide essential services and opportunities for individuals, families, organizations, and businesses across Washington. Public trust is built on the knowledge that government is operating as efficiently, openly and successfully as possible. I value highly the essential role our Office plays in providing that knowledge to the public.

Troy Kelley
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The State Auditor’s Office is responsible for auditing all units of government in Washington, which puts us in a unique position not only to see where financial, compliance or performance problems exist, but also to provide recommendations, training, and guidance to help government officials fix these problems.

To accomplish that, in 2014 the State Auditor’s Office laid out strategic goals and established specific performance measures that we will monitor routinely to ensure that our agency is operating efficiently, effectively and transparently enough to meet State Auditor Kelley’s high expectations.

Better government is the bottom line. When we perform audits in a way that encourages governments to implement our recommendations, we accomplish our mission and build our vision of government that works for citizens. For example, since the State Auditor’s Office began conducting performance audits in 2006, state agencies report implementing 86 percent of our performance audit recommendations and savings of more than $1 billion.

It is not enough to simply audit governments. Our agency needs to use what it learns in the audits it conducts to help all governments improve, find solutions and emulate best practices. Because we do more than audit – we make a difference.

The Local Government Performance Center, created in 2012 and expanded by State Auditor Kelley after he took office in 2013, helps local governments reduce costs and improve results by applying the lessons we learn from our audits. The Local Government Performance Center won the prestigious 2014 “Excellence in Accountability Award” from the National State Auditors Association.

In line with our responsibility to help reduce risk to government, in 2014 we embarked on a long-term, ongoing examination of Information Technology security risks in state and local governments. One performance audit revealed how state agencies sometimes fail to safeguard confidential and security information when selling surplus computers and other devices to the public. A second performance audit examined the state’s IT security posture. Although the state has high security standards, our testing found numerous issues in the security practices of some agencies and significant discrepancies in agency-reported compliance with those standards. We expect to continue working with the Office of the Chief Information Officer, state agencies and local governments to examine and review IT security postures, with an eye to reducing risk to government.

By demonstrating our professionalism, independence, respect and integrity, we expect state and local officials to be partners in making government work better, cost less, deliver higher value, and earn greater public trust.
Also in 2014, State Auditor Kelley and his executive team:

- Continued to use Lean strategies across the agency to improve efficiency and reduce costs, including further refining our organizational structure and combining office spaces to reduce the agency’s physical footprint in Olympia and Tumwater
- Hired a new chief information officer and a chief information security officer
- Enlarged outreach of the Local Government Performance Center through training, support and development of the new local government Financial Intelligence Tool (FiT)
- Conducted Transparency and Open Government training sessions across the state to help more than 700 local government officials comply with the Open Public Meeting Act, Public Records Act, records retention best practices, and the Open Government Trainings Act of 2014
- Refined the online filing process for local governments and conducted extensive training in all 39 Washington counties
- Reported on 59 investigations of misappropriation from state and local governments totaling almost $800,000
- Further improved timeliness of Whistleblower investigations
- Released significant performance audits of major state programs and systems, and increased the number of performance audits conducted
- Applied a new notification protocol to allow local officials ample time to incorporate audit rate changes in their budget process
- Increased the agency’s legislative presence
- Launched a revised State Auditor’s Office website that is more intuitive, user centered, and easier to search
- Expanded the agency’s social media presence on Facebook, Twitter, LinkedIn, and YouTube to increase transparency and accessibility.
Local Government

We take our statutory responsibility to examine the financial affairs of all local governments statewide very seriously. There are more than 2,260 individual local governments statewide, covering 36 government types including cities, counties, school districts, ports, fire districts, public utility districts, and many more. In 2014, our Office conducted 2,237 audits of local government.

Identifying top areas of audit concern for local governments
We use the broad issues and patterns identified in our audits to develop resources that can help all levels of government work better, cost less and earn greater public trust. In 2014, we identified the top three recurring areas of concern.

1. Lack of internal controls over accounting, financial reporting, cash receipting and expenditures
Lack of internal controls in key financial systems continues to account for approximately 42 percent of all audit issues identified by our auditors. To help local governments assess their own internal control environment for accounting and financial reporting, we have compiled many tools on our Local Government Performance Center webpages. They include two new resources focusing on internal controls in information technology dependent systems.

- **Third-Party Receipting** – Third-party receipting involves electronic payments collected by credit and debit cards or Automated Clearing House (ACH) transactions of electronic checks, online payments, etc. These electronic payments and receipts are processed for a local government by a third-party provider. The requirements associated with third-party receipting can be complicated and vary depending on the nature of the government. This guidance can help local governments ensure that public funds are safeguarded and deposited on time.

- **Cyber Security Advice** – Malware infections on government computers can lead to damaging cyber-attacks and fraudulent wire transfers. The best practices outlined in this guidance can help local governments reduce the risk associated with online banking and electronic fund transfers (EFT). Although nothing can eliminate all risks, having multiple layers of security and informed, vigilant local government users will minimize the risk.

The State Auditor's Office is committed to exploring additional tools and resources for local governments to strengthen their internal controls, including security, over information technology systems.

2. Failure to comply with federal grant requirements
Local governments continue to struggle to comply with federal grant requirements. We reported problems with grant compliance in 69 of the 450 federal audit reports we published during 2014 – about 15 percent. Local governments can find information on the basics of federal grant management on our website; we also partner with the Washington Finance Officers Association (WFOA) to give several classes each year on the topic. The classes provide an overview of grant requirements and identify commonly encountered areas of audit concern.

Number of local government reports released by audit type

<table>
<thead>
<tr>
<th>Type</th>
<th>Number</th>
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<tbody>
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<tr>
<td>Financial</td>
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<tr>
<td>Federal</td>
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<td>Financial</td>
<td>407</td>
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<tr>
<td>Special</td>
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</tr>
<tr>
<td>Investigations</td>
<td>13</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>2,237</strong></td>
</tr>
</tbody>
</table>
3. Declining financial condition
On August 7, 2014, we issued our second report highlighting signs of declining financial conditions identified by audits; our initial report was issued in November 2012. Local governments continue to face a combination of rising costs and constrained revenues that could jeopardize their financial stability. To help local governments manage their financial health, the Local Government Performance Center within the State Auditor’s Office is assembling new resources to help local government leaders identify and respond to financial problems without waiting for an audit to detect them. (See page 9 for more about the Financial Intelligence Tool initiative.)

Audits of school district Alternative Learning Experience programs
In 2013, the state Legislature passed ESSB 5946 which has been codified into RCW 28A.232.010(3)(c). It requires school districts to receive biennial audits of their Alternative Learning Experience (ALE) programs.

District management is responsible for ensuring that their programs comply with applicable ALE requirements. This includes the design, implementation and maintenance of internal controls. Our audits examine a district’s compliance with state laws and regulations and with its own policies and procedures. In 2014, we audited 39 percent of ALE enrollment statewide, examining 49 ALE programs in 18 school districts. In nine of the 18 audited districts, we questioned a total of $493,806 in ALE funding. The primary causes of questioned funding included:

• Offering high school programs that did not generate credits toward a high school diploma
• Not obtaining signed statements from parents certifying they understand the difference between ALE and home-based instruction
• Not conducting and/or documenting required monthly evaluations of student progress

Our audits of the ALE programs in individual school districts are available on the Schools page of our website.

Local Government Financial Reporting
All local governments are required by statute to file their annual financial reports with our Office within 150 days after the end of their fiscal year. A recent report released by our Office found that local governments still struggle to file their reports on time or at all.

In both 2011 and 2012, more than 700 of 1,956 local governments did not file their reports as required for each year. In 2014, our Office stepped up its outreach efforts, offering 41 trainings and workshops on requirements and how to file. As a result, about 100 more local governments filed their annual reports as required that year. However, more than 600 local governments still did not report as required.

The chart (right) illustrates the government types with the greatest number of late filers, incomplete filers and non-filers for each of the last three consecutive fiscal years (2011-2013).

Local governments that did not file as required for three consecutive years, 2011-2013
By percent: By number:

- Fire Districts (45)
- Diking/Drainage (46)
- Water/Sewer District (29)
- Cemetery Districts (28)
- Irrigation/Reclamation (28)
- Hospital Districts (22)
- Other* (74)


Local governments included in the chart shown are identified as any of the following: (1) late filers, (2) incomplete filers or (3) non-filers for each of the last three consecutive fiscal years (2011-2013).
Why is this a problem?
If local governments do not file annual reports as required, our Office cannot independently review the public funds they received or how they were spent. Between 2011 and 2012, more than $2.2 million in expenditures could not be audited because local governments did not submit their annual financial reports as required.

There are consequences for taxpayers and local governments when there are unaudited public funds. This lack of transparency makes it difficult, if not impossible, for taxpayers to hold local governments accountable. This indication of a lack of fiscal responsibility may lead to reduced future funding and other negative consequences, such as poor bond ratings or trouble arranging credit and loans.

How does this happen, and what can be done to help?
The most commonly faced obstacles to filing reports complete and on time arise from the very nature of local governments: tight budgets, part-time staff or volunteers, and inadequate oversight by elected or appointed officials.

To help overcome some of these obstacles, we established an online annual reporting system in 2012, which is a quick and easy way to file annual reports and allows local governments to easily generate print-ready financial statements.

In addition, subject-matter specialists staffing the Auditor’s Office Helpdesk – accessed within the Client Portal – can answer any questions about filing an annual financial report, often within one business day. Online filing is not required, however we strongly encourage local governments to do so, because it ensures required schedules are filed using the latest versions of reporting guidance. In 2014, we again undertook significant outreach to encourage all local governments to file online by providing free, monthly workshops.

Users access the online filing system through their password-protected account in our Client Portal at https://portal.sao.wa.gov/saoportal
Local Government Performance Center

Performance Center continues to help governments work better, cost less

It is exciting to be able to help governments through the work we do, not just point out the problems we find. The Local Government Performance Center was established to do just that.

The Performance Center helps local governments solve problems, reduce costs and improve the value of their services to citizens by offering resources such as training, tools and technical assistance. For example, after an intensive analysis of its process through the Center’s Lean Academy, Whatcom County reduced the time it takes to issue a single-family home building permit from 31 days to nine. Over time, we hope to be able to help more local governments more quickly and more economically than we can through individual audits.

In 2014, the Performance Center continued its mission to provide non-audit services and resources to help local governments deliver better results. We expanded the number of classes offered as well as the types of classes, adding financial management and open government to the growing list of important topics covered by the Center.

Notably, we tripled the number of Lean Academies offered this year. Participating local governments achieved impressive results, including:

- Permit processing times cut in half
- Better transit rider notification, which reduced the number of calls to customer service representatives
- Simplified travel policies and payment processes

Local Government Performance Center: Growth over three years

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<td>employees trained</td>
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<td>Types of training classes</td>
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<td>offered</td>
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<tr>
<td>Lean Academy workshops</td>
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</table>
Open Government & Transparency trainings

Strong “sunshine laws” are crucial to assuring government accountability and transparency. In Washington, those laws provide for open public records and open public meetings. Local government officials must have a thorough grasp of these laws, and training is a key component in helping them correctly implement and comply with the laws. To that end, through the Performance Center, we offered seven Open Government and Transparency trainings around the state, with more than 700 local officials attending. While we began planning these training sessions before legislation was introduced, we were pleased that the material we presented met the requirements of the Open Government Trainings Act of 2014.

In addition, the Center partnered with the Municipal Research and Services Center of Washington to develop a set of tools and resources that offer practical advice along with best practices in records management and compliance with the Open Public Meetings Act and the Public Records Act.

Helping local governments become fiscally fit

In 2014, the Performance Center worked with local government officials, associations and other stakeholders to develop a fiscal health tool to help local governments in their role as stewards of financial resources. Our Financial Intelligence Tool, or FIT:

- Provides standard, transparent, understandable, and easily accessible financial information
- Guides financial decision makers of any experience level
- Assists in telling a government’s financial story

Governments that report financial information using the cash basis of accounting will be able to download the tool from the Client Portal on our website in early 2015. Data they have already submitted to us will automatically populate five key financial ratios that will give local governments a snapshot of their financial health.

Initially, governments that report using Generally Accepted Accounting Principles (GAAP) will only be able to download a template and manually enter their financial data. In the future, the FIT tool will also be available to entities that report under GAAP.

An illustration of the new FIT website within the Auditor’s Office’s Client Portal, launched in January 2015.
State Government

**Comprehensive Annual Financial Report (CAFR) for fiscal year 2014**

We completed the 2014 CAFR audit, which covered the fiscal year that ended on June 30, 2014, and issued our “unmodified” opinion on the report in October 2014. That was just 123 days after year’s end, the shortest completion timeline for any state in the nation. The “unmodified” opinion means that in our professional judgment these financial statements fairly present the state’s financial position.

Each year, following this audit, we also publish the CAFR Summary, a five- to 10-page document that serves as a “snapshot” of the state's financial position, including revenues, expenditures, cash balances and debt. The summary highlights the lengthy financial statements and some of the financial challenges facing the state, including the unfunded liabilities associated with workers compensation, supplemental pension, cost-of-living adjustments, state pension systems, post-employment benefits, and the Guaranteed Education Tuition program.

The 2014 CAFR Summary can be found in the Annual Reports page of our website.

**Statewide Single Audit (SWSA, or the Federal Compliance Audit) for fiscal year 2013**

State agencies that spend at least $500,000 in federal financial assistance annually are required to obtain an audit pursuant to the federal Single Audit Act of 1984. We provide that service for the state of Washington on behalf of the federal grantor agencies. These audits are performed in accordance with Generally Accepted Government Auditing Standards (GAGAS) and are an assessment of internal controls over federal programs, tests of how those controls are working, and tests of compliance with federal requirements.

Our objective is to determine whether state agencies complied with federal requirements that could have a direct and material effect on a major federal program, and to report on noncompliance.

A comprehensive single audit report is published by the Office of Financial Management (OFM) in March every year. We are in the process of completing our audit for the fiscal year that ended on June 30, 2014.

In 2013, Washington received $14.9 billion in cash and other federal assistance. We audited 31 programs that received $8.7 billion – about 58 percent of all federal dollars the state received. A summary report of the audit can be found in the Annual Reports page of our website. The full report is published on OFM’s website.
State agency accountability audits in 2014

We performed 29 individual accountability audits for state agencies and commissions in 2014. These audits are designed to provide reasonable assurance of compliance with legal requirements and to determine if adequate internal controls are in place. We did not examine every transaction, activity or area. Instead, our audits focused on identifying and examining those transactions, activities or areas that pose the highest risk of noncompliance.

We reported nine findings and six management letter recommendations as part of these audits. Here, we briefly summarize some of the important issues we identified.

**Washington State Historical Society:** We found that the agency lacked adequate internal controls to safeguard and account for its capitalized and small-and-attractive assets. The agency had about $215,000 in capitalized assets that were not adequately inventoried or monitored due to a lack of policies and procedures. Additionally, the agency reported $789,682 in local fund expenditures related to vendor payments and $150,000 in purchase card expenditures. We found that the agency had ineffective or nonexistent controls related to the use of purchase cards and vendor payments. We also noted certain matters that we communicated to the Executive Ethics Board for review during the course of the audit.

**Washington State Parks and Recreation Commission:** We found that the Commission lacked adequate internal controls over cash receipting and Discover Passes, which accounted for nearly $5.5 million of the Commission’s 2013 revenues. The Commission did not have written inventory procedures to ensure the proper tracking of distribution and printing of the passes, and lacked adequate controls over the receipting of funds related to the passes. We recommended the Commission strengthen controls to reduce the risk of loss or misappropriation of public funds.

Additionally, we found that the Commission lacked adequate internal controls to account for fuel card purchases. The lack of reviews and reconciliations over fuel card purchases increased the risk that inappropriate purchases of fuel could go unidentified.

**Board of Volunteer Firefighters and Reserve Officers:** We found the Board did not have adequate internal controls over both its cash receipting and its pension tracking systems. The Board collected approximately $1.1 million in pension and disability fees during 2013 and made disbursements of more than $12.7 million to pensioners and beneficiaries. Our audit identified weakness in internal controls and made recommendations to reduce the risk that benefits could be collected and misappropriated.

**Washington State School for the Blind:** We found the school lacked internal controls to adequately monitor and account for its local funds.

In 2015, we will continue to perform accountability audits of state agencies and commissions, which will also include several institutions of higher education. These audits may include a review of local funds, which are monies under a state agency’s control, but are not deposited with the State Treasurer.
## State agencies audited in 2014, by report date

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<th>State agency</th>
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<td>Washington State Asparagus Commission</td>
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<td>Washington State Blueberry Commission</td>
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<td>Washington State Apple Commission</td>
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<td>Washington State Dairy Products Commission</td>
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<td>Department of Ecology</td>
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<tr>
<td>Office of the Attorney General</td>
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<tr>
<td>Department of Fish and Wildlife</td>
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<td>Washington State Gambling Commission</td>
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<td>Pollution Liability Insurance Agency</td>
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<td>State Lottery Commission</td>
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<td>Department of Early Learning</td>
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<td>Washington Horse Racing Commission</td>
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<td>Student Achievement Council</td>
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<tr>
<td>Washington State Recreation and Conservation Office</td>
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</table>

We also published a report on **personal service contracts** in May 2014.
Energy Audits

The Energy Independence Act, also known as Initiative 937, was approved by voters in 2006. It requires certain electric utility companies in the state to invest in new renewable energy sources and energy conservation programs. Each utility must establish and subsequently achieve its targets.

Annual renewable energy targets are defined in the Act as a percent of retail electricity sales. Targets increase over time from 3 percent in 2012, to 9 percent in 2016, and 15 percent in 2020.

Biennial conservation targets are not established in the same manner. Utilities follow a prescribed methodology to determine their unique level of achievable conservation. For the upcoming 2014-2015 conservation compliance period, the targets range from 0.4 percent to 1.5 percent of retail electricity sales.

The Act applies to all electric utilities that serve more than 25,000 customers in the state. We have authority to audit 12 of the 17 qualifying utilities.

We have issued all of the compliance reports for the 2010-2011 conservation and the 2012 renewable energy compliance periods. We have issued eight of the 2012-2013 conservation and 10 of the 2013 renewable energy compliance reports.

Specific to the reports already issued, all utilities were in compliance with both their conservation and renewable energy targets. We expect to complete the remaining audits during the first quarter of 2015. Results of these audits are available online on the Energy page of our website.

Read more about the targets for energy conservation on the Department of Commerce’s website at www.commerce.wa.gov/Programs/Energy/Office/EIA/Pages/default.aspx.
The Performance Audit division’s work includes a blend of long-term audits of major state programs and shorter evaluations designed to give policy-makers options to help them meet the state’s challenges. This section discusses some of the 10 performance audits published in 2014. We will follow up on progress the audited agencies and programs made in implementing our recommendations in our next Performance Audit Progress Report.

Safe Data Disposal: We checked a sample of state computers sent for surplus or sale and found 9 percent contained confidential data that should have been removed, such as Social Security numbers. After our audit found weaknesses in the data removal system, state government organizations responded swiftly to improve their processes and better protect confidential data.

Opportunities to Improve State IT Security: Compliance and application security testing showed state agencies are not in full compliance with Washington’s IT security standards. We found those standards do align closely with leading practices, as does Washington’s statewide approach to security management.

Debt Offset Programs: A tool to help Washington collect delinquent debt: There are businesses that owe money to the state, such as delinquent taxes. If Washington had a comprehensive offset program for business debt, it could quickly intercept payments state agencies and the federal government make to businesses, when those businesses owe money to the state.

Electronic Benefit Transfer Cards: We made recommendations to improve prevention of card use by ineligible persons, such as increased use of data-matching for identifying high-income clients, discontinuing payments sooner after the death of the client, and scrutinizing out-of-state card use.

Medicaid Managed Care Program Oversight: We found that weaknesses in state oversight led to managed care organizations paying providers more than was appropriate, which in turn may have led to the state paying higher premiums to these organizations.

Post-Adoption Services: Most parents who adopted children from foster care said in a survey that they do not need additional post-adoption services. However, some families cannot get all the services they require, especially for the children with the greatest needs.

Since we issued our first performance audit in 2007, governments report they saved about $1 billion and implemented 86 percent of our issued recommendations. We expect additional savings as governments continue to adopt our performance audit recommendations to improve the efficiency, effectiveness and economy of programs.
Investigations

The State Auditor’s Office conducts three types of investigations: fraud, citizen hotline, and state employee whistleblower. This section features highlights of our 2014 investigations.

Fraud
In 2014, we reported on 59 investigations of misappropriation from local and state governments totaling almost $800,000. The table at right shows the value of misappropriations by category.

Our largest investigations in 2014 involved three local governments.
- A city employee used procurement card purchases to misappropriate $117,410 and convert the funds to personal use.
- A port suffered a loss of at least $185,156 from its aviation fuel system. Camera recordings tied a portion of the loss to a vendor used by the port.
- A port lost at least $116,629 in revenue that was never deposited. We determined a department manager was responsible for at least $89,024 of the cash misappropriation.

Our Office also performs an extensive amount of educational outreach by providing presentations and trainings throughout the state at government accounting and auditing professional association conferences.

Citizen Hotline
Our Office operates a hotline for citizens and government employees to report assertions of government fraud, waste and abuse. It is also a place to report government efficiency or outstanding achievement.

In 2014, we received 535 hotline submissions and opened investigations into 429 of them. Hotline submissions are typically received through our website. However, if individuals want to leave a voice message about their concern, they can call our toll-free hotline at 1-866-902-3900.

Whistleblower Program
The state’s Whistleblower Act provides an avenue for state employees to report suspected improper governmental action.

In 2014, we received 224 reports of improper governmental action and opened investigations into 47 of them. We published 25 whistleblower reports in 2014 and, in 14 of those cases, we found reasonable cause to believe an employee had engaged in improper governmental action.

In the past year, the Whistleblower team has used Lean process improvement techniques to decrease the average time of investigations, implemented performance measures, and made improvements to IT systems.

### Fraud investigations in 2014

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<thead>
<tr>
<th>Misappropriation by type</th>
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<td>Cash receipting</td>
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<td>Payments</td>
<td>$244,445</td>
</tr>
<tr>
<td>Payroll</td>
<td>$ 50,803</td>
</tr>
<tr>
<td>Other</td>
<td>$222,116</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$797,302</strong></td>
</tr>
</tbody>
</table>
Quality Assurance

It’s reasonable to ask “Who audits the auditor?”

We are committed to continuously improving how efficiently we carry out our work, and hold ourselves to the highest standards of quality in the audit work we do. We do it because it’s right, and because we know Washington citizens expect no less of us.

Our Office is subject to external peer reviews every three years to ensure our audits satisfy government auditing standards. These peer reviews are conducted by the National State Auditors Association with the National Association of State Auditors, Comptrollers and Treasurers.

The Office received a “clean opinion” on its 2013 external peer review. The reviewers concluded the Office had a well-designed quality control system, and applicable audit policies and standards were complied with in almost all cases. We conduct so many different types of audits, across so many different teams, that it takes a concerted effort by everyone involved to maintain such a high standard of quality.

We are also audited every two years by an independent public accountant under contract with OFM. This Cabinet-level agency provides information, fiscal services and policy support to the Governor, Legislature and state agencies. Such audits generally focus on our administrative operations.

Like all state agencies, we are required to report on how we plan to resolve any audit issues, and the Director of OFM issues an annual report on the audit resolution status. These reports are available to the public on the OFM website.

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